

# THE ISSUANCE OF SECURITIES IN REORGANIZATIONS AND ARRANGEMENTS UNDER THE BANKRUPTCY ACT AND THE PROPOSED BANKRUPTCY ACT

Beginning with the enactment of the Securities Act of 1933,<sup>1</sup> it has been the policy of the federal government to supervise closely the issuance and sale of securities by requiring their prior registration with the Securities and Exchange Commission. The disclosure of important facts concerning the securities is required before securities can be legally issued. The general purpose of the disclosure requirements is to enable investors to make a realistic appraisal of the merits of the security and thus make an informed investment decision. However, as a result of certain exemptions from the registration requirement, securities issued in corporate reorganizations under Chapter X of the Bankruptcy Act, and securities issued in arrangements under Chapter XI of the Bankruptcy Act are rarely registered. The purpose of this comment is to examine critically the principal exemptions applicable in the corporate reorganization context, § 3(a)(10) of the Securities Act of 1933,<sup>2</sup> § 264(a)(2) of Chapter X,<sup>3</sup> and § 393(a)(2) of Chapter XI<sup>4</sup> in order to determine their purposes, their present uses and abuses, and their suggested continuance under the proposed Bankruptcy Act and the proposed American Law Institute Securities Code.

## I. LEGISLATIVE HISTORY OF THE BASIC STATUTES

### A. *The Securities Act of 1933*

The Securities Act of 1933 was the congressional response to numerous abusive practices prevailing in the 1920's. The basic thrust of the Act is to require the disclosure in a registration statement of material financial and other information concerning the security and prohibit misrepresentation and fraudulent practices in connection with the sale of securities. Stated differently, it was not the intention of Congress to regulate the quality or fairness of the securities. Section 5 of the Act requires that all securities be registered before they may be sold in interstate commerce. The lack of any actual need for

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<sup>1</sup> 15 U.S.C. §§ 77a-77aa (1970).

<sup>2</sup> 15 U.S.C. § 77c(a)(10) (1970).

<sup>3</sup> 11 U.S.C. § 664(a)(2) (1970).

<sup>4</sup> 11 U.S.C. § 793(a)(2) (1970).

investor protection via registration provides no independent grounds for exemption in any case which is not otherwise exempt. The requirements of registration are rigorous and often involve substantial amounts of money and time—resources not usually present in reorganizations. While registration of all reorganization securities would impose a substantial hardship on the debtor and his creditors, this hardship is no grounds for exemption. The United States Court of Appeals for the First Circuit has stated:

We do not agree with any language . . . which might be construed as indicating that an issue of stock—otherwise subject to registration—could be excused therefrom on the basis that the time requirements of the registration procedure would be inimical to a proposed plan of reorganization.<sup>5</sup>

There are, however, certain exemptions from the broad reach of § 5.<sup>6</sup> Of primary concern in the bankruptcy context is the exemption presently found in § 3(a)(10). As originally enacted, the exemption was part of a broader exemption found in § 4(3). Section 4(3) stated in part:

The provisions of § 5 shall not apply to any of the following transactions: . . . .

. . . .

[T]he issuance of securities to the existing security holders or other existing creditors of a corporation in the process of a bona fide reorganization of such corporation under the supervision of any

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<sup>5</sup> SEC v. Bloomberg, 299 F.2d 315, 318 (1st Cir. 1962).

<sup>6</sup> See, e.g., the exempt transactions of §§ 4 and 3(a)(9)-(11) and the exempt securities of § 3(a)(1)-(8). In addition, certain exemptions are inherent in the definitions of § 2. A peculiar application of this latter approach of exemption by definition must be noted. Very early in the SEC's history the terms "sale" and "value" were interpreted in such a manner that no sale was held to take place for the purposes of the registration requirement in the exchange of stock in certain mergers, consolidations, reclassifications, and transfers of assets. The position was eventually formalized in rule 133. The "no sale" theory and rule 133 became "instrument[s] of evasion of the law and a means by which illegal distributions of securities [were] achieved in secrecy and in violation . . . of the registration and disclosure provisions of the Securities Act. . . ." SEC Securities Act Release No. 3728 (Dec. 17, 1956). Huge numbers of securities were offered without registration. Eventually a number of limitations and qualifications were developed and rule 133 was amended several times. Finally in 1972, after much study, rule 133 and the "no sale" theory were specifically rejected by the adoption of rule 145. See generally 1 L. LOSS, *SECURITIES REGULATION* 518-541 (2d ed. 1961) [hereinafter cited as LOSS]; 4 LOSS 2559-2573 (Supp. 1969). For a consideration of the impact of rule 145 on blue sky laws see Note, *State Regulation of Securities Issued in Corporate Reorganizations: A Cloud in the Blue Sky*, 25 CASE W. RES. L. REV. 149 (1974). The note contains a collection of citations to the articles on rule 133 and the "no sale" theory at 150 n. 6.

The theory had little impact on reorganizations carried out under the Bankruptcy Act. But it is primarily of historical interest today both for its own story and as one example of an analogous situation showing the growth of the SEC's concern for extensive disclosure.

court, either in exchange for the securities of such security holders or claims of such creditors or partly for cash and partly in exchange for the securities or claims of such security holders or creditors.<sup>7</sup>

The purpose of the section was to

exempt the distribution of securities during a bona fide reorganization of a corporation when such a reorganization is carried on under the supervision of a court.

Reorganizations carried out without such judicial supervision possess all the dangers implicit in the issuance of new securities and are, therefore not exempt from the act. For the same reasons the provision is not broad enough to include mergers or consolidations of corporations entered into without judicial supervision.<sup>8</sup>

Section 4(3) was split into several separate sections and moved from § 4 to § 3 as a part of amendments to the Securities Act of 1933 contained in the Securities Exchange Act of 1934.<sup>9</sup> As a part of these amendments, § 3(a)(10) was enacted. It exempts

[a]ny security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.<sup>10</sup>

The House Report states that § 3(a)(10) was intended to extend the provisions of § 4(3).

to cover readjustments of rights of holders of securities, claims, and property interests under court or similar supervision, even though the original issuer of the securities, debtor on the claims, or owner

<sup>7</sup> Act of May 27, 1933, ch. 38, § 4(3), 48 Stat. 75-77.

<sup>8</sup> H.R. REP. NO. 85, 73d Cong., 1st Sess. 16 (1933).

<sup>9</sup> Act of June 6, 1934, ch. 404, 48 Stat. 881. It has been the consistent position of the SEC that this amendment did not alter the essential nature of these exemptions as transaction exemptions. Thus although listed as an exempt security, any security issued pursuant to the § 3(a)(10) exemption is exempt only for its initial issuance. Another exemption must be found for any subsequent resale without registration. *See* 1 LOSS at 709-10; SEC Securities Act Release No. 646 (Feb. 3, 1936). *But see* Shaw v. United States, 131 F.2d 476 (9th Cir. 1942). For current applications of this concept see SEC No Action Letter, Seaferro, Inc., (March 23, 1971) and SEC No Action Letter, Decicom Systems, Inc., (March 2, 1973).

<sup>10</sup> 15 U.S.C. § 77c(a)(10) (1970).

of the property in which interests are held, is not itself in the process or reorganization.<sup>11</sup>

The Report also added that

[a] limitation on the exemption has been added by the conferees in the requirement that the approval of the court or official, in order to be effective, must follow a hearing on the fairness of the terms and conditions of the issuance and exchange of the securities at which persons who are to receive such securities shall have a right to appear. Security holders' committees are to be denied the opportunity of obtaining exemptions under this section if they secure and exercise an exclusive right to appear for their depositors at hearings on plans of reorganization.<sup>12</sup>

An examination of §§ 3(a)(10) and 4(3) and their legislative histories reveals the point at which the § 3(a)(10) exemption fits into the overall federal scheme of investor protection. The implication of the statement that reorganizations carried out without judicial supervisions are fraught with the same potential dangers as new issues of securities shows that there is nothing inherent in securities issued in reorganizations that obviates the need for investor protection through disclosure. However, unlike other issues of securities, the need for investor protection in reorganization issues is satisfied not by disclosure of information through registration, but by judicial supervision. Thus, shortly after § 3(a)(10) was added to the Securities Act of 1933, the SEC stated that

the whole justification for the exemption afforded by section 3(a)(10) is that the examination and approval by the body in question of the fairness of the issue in question is a substitute for the protection afforded to the investor by the information which would otherwise be made available to him through registration.<sup>13</sup>

It must be noted that the § 3(a)(10) exemption is unique among the provisions of the federal securities statutes in that it seeks to provide investor protection in the same manner as state blue sky laws, *i.e.*, through a requirement of substantive fairness. Under the other sections of the federal securities acts it is possible to issue worthless or nearly worthless securities as long as there is adequate disclosure of value and no violation of anti-fraud provisions found in the acts. Under § 3(a)(10), it would seem possible to issue securities without

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<sup>11</sup> H. R. REP. NO. 1838, 73d Cong., 2d Sess. 40 (1934).

<sup>12</sup> *Id.*

<sup>13</sup> SEC Securities Act Release No. 312 (March 15, 1935).

any, or at least minimal, disclosures of information<sup>14</sup> to the offerees as long as the court approves the terms and conditions of the issuance. The general securities provisions rely on the premise that an investor is qualified to make an investment decision when provided with all the material facts. Section 3(a)(10) relies on the premise that a judge or administrator is qualified to evaluate the substantive fairness of the terms of a security without the assistance of a formal registration statement or a formal requirement for similar information. In the reorganization context the soundness of the latter premise ultimately depends on the thoroughness and expertise of the judge in supervising the transaction.

## B. *The Bankruptcy Act, Chapters X and XI*

### 1. Historical Antecedents

Prior to 1934, the dominant mode of corporate reorganization was the equity receivership. This method of reorganization was severely criticized and in 1934 a formal statutory reorganization procedure, § 77B,<sup>15</sup> was added to the bankruptcy laws.<sup>16</sup> The section was comprehensive and represented a major advance over the equity receivership. It is sufficient to note that this statutory procedure contained an exemption from the securities statutes. Section 77B(h) stated in part that

[a]ll securities issued pursuant to any plan of reorganization approved by the court in accordance with the provisions of this section . . . shall be exempt from all the provisions of the [Securities Act of 1933 except the antifraud provisions].<sup>17</sup>

Neither the House<sup>18</sup> nor the Senate Reports<sup>19</sup> discuss the rationale for the exemption, and exactly how Congress intended the exemption to

<sup>14</sup> It may be possible that rule 10b-5 and other anti-fraud provisions require the disclosure of a minimum amount of information and, of course, once any information is disclosed the seller may not omit any information necessary to make the statements made not misleading. See 15 U.S.C. § 77c(a)(2) (1970); rule 10b-5, 17 C.F.R. § 240.10b-5 (1974).

<sup>15</sup> Act of June 7, 1934, ch. 204, 48 Stat. 111.

<sup>16</sup> The equity receivership remained an alternative form of reorganization until 1944 when the Second Circuit held that a receiver was irregularly appointed anytime there was a statutory alternative to the equity receivership. *New England Coal & Coke Co. v. Rutland R.R.*, 143 F.2d 179 (2d Cir. 1944). Since that time all federal reorganizations and arrangements have been pursuant to the various provisions of Title 11.

<sup>17</sup> Act of June 7, 1934, ch. 204 § 77b(h), 48 Stat. 111.

<sup>18</sup> The House Report, H.R. REP. NO. 194, 73d Cong., 1st Sess. (1933) discusses subsection (h) at page 7 without reference to the securities exemption.

<sup>19</sup> The Senate Report, S. REP. NO. 482, 73d Cong., 2d Sess. (1934) discusses subsection (h) at page 9 without reference to the exemption.

be reconciled with the exemptions in the Securities Act of 1933 is not clear.<sup>20</sup>

## 2. Chapters X and XI

Extensive study by the SEC,<sup>21</sup> various congressional committees, and the National Bankruptcy Conference<sup>22</sup> eventually prompted the enactment of the Chandler Act in 1938.<sup>23</sup> The act established a reorganization procedure in Chapters X and XI which has continued to this date with few major changes.<sup>24</sup>

Chapter X is designed for "reorganization in the grand manner."<sup>25</sup> It contemplates a lengthy procedure in which creditors and security holders are given maximum protection against unscrupulous conduct by insiders. The entire proceeding is a matter of public concern, with the SEC playing a major role. The court is charged with extensive supervisory responsibilities. Among other things the court

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<sup>20</sup> Probably the impact of the Securities Act was not fully considered because it had been in effect only for a short time. The House Report on the bill which enacted § 77B is dated June 2, 1933 and the Securities Act was passed on May 2, 1933. The Senate report is dated March 15, 1934, and the bill itself was passed on June 7, 1934 one day after the passage of the Securities and Exchange Act of 1934 which put § 3(a)(10) into its present form.

<sup>21</sup> SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PARTS I-VII (1934-1940).

<sup>22</sup> The National Bankruptcy Conference arose during this time as a group of persons interested in revising the 1898 Act and unsatisfied with the proposals for reform which had been put forth. After explaining the dissatisfaction of the various parties, James McLaughlin explained the group's origin in 1932:

The result was what later came to be styled the National Bankruptcy Conference. Two referees, four lawyers, and one full time law teacher met at a lawyer's home in Wellesley, Mass., one week end in June, 1932, and, pursuant to a declared intention to draft all necessary amendments to the Act by Monday next, spent three days arguing about the definitions in section I. . . . Additional members were added from time to time as particular interest or particular competence appeared or as particular subject matter called for the introduction of specialized talent. . . . Members occasionally added for reasons of diplomacy or promotion did not seriously impair the work. Aged conversatives impressed with the perfections of the Act of 1898 died, withdrew from active participation or gradually acquired an almost human elasticity of mind.

McLaughlin, *Aspects of the Chandler Bill to Amend the Bankruptcy Act*, 4 U. CHI. L. REV. 369, 376 (1937) [hereinafter cited as McLaughlin].

<sup>23</sup> 11 U.S.C. § 1 *et seq.* (1970) (originally enacted as Act of June 28, 1938, ch. 575, 52 Stat. 840). See REPORT OF THE COMMISSION ON THE BANKRUPTCY LAWS OF THE UNITED STATES, H. R. DOC. NO. 93-137, 93d Cong., 1st Sess., part I, 237-244 (1973) [hereinafter cited as COMMISSION REPORT]; and McLaughlin at 374-378, for a short history of these various studies.

<sup>24</sup> The major changes occurred in 1952. See Act of July 7, 1952, ch. 576, 66 Stat. 420.

<sup>25</sup> Rostow and Cutler, *Competing Systems of Corporate Reorganization: Chapters X and XI of the Bankruptcy Act*, 48 YALE L. J. 1334 (1939).

must make an initial determination that the petition is filed in good faith<sup>26</sup> and that it is reasonable to expect that a plan of reorganization can be effected.<sup>27</sup> Existing management is routinely displaced<sup>28</sup> and a trustee is appointed to operate the business. The trustee prepares a plan of reorganization which is usually submitted to the SEC for an advisory report.<sup>29</sup> The court then conducts a hearing on the plan to which all interested parties receive notice and in which they have the right to participate.<sup>30</sup> The court must find that the plan is fair and equitable and feasible.<sup>31</sup> After the court approves the plan it is mailed along with any opinions of the court and the SEC report to all creditors and stockholders affected by it.<sup>32</sup> Only after this approval may acceptances be solicited.<sup>33</sup> Subject to the "cram down" rules,<sup>34</sup> when the plan receives the requisite two-thirds approval it may be confirmed by the court and consummated.

Chapter XI contemplates a much quicker, less extensive procedure. Chapter XI substitutes the protections of Chapter X for a faster, simpler, more economical substitute to liquidation. The debtor usually remains in possession<sup>35</sup> and continues to operate the busi-

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<sup>26</sup> 11 U.S.C. §§ 541, 546 (1970). In the overall context of Chapter X the good faith requirement has a somewhat broader meaning. Basically, it is "a criterion which enables the judge to determine, on the particular facts presented whether the financial, economic and legal situation of the debtor is one within the contemplation of Chapter X." 6 COLLIER, *BANKRUPTCY* 1019 (J. Moore ed. 1972) [hereinafter cited as COLLIER].

<sup>27</sup> 11 U.S.C. § 546 (1970).

<sup>28</sup> 11 U.S.C. §§ 556-559 (1970). In cases where the debtor has over \$250,000 indebtedness an independent trustee must be appointed. In all other cases the court may appoint a trustee or trustees.

<sup>29</sup> 11 U.S.C. § 572 (1970). This is only mandatory in cases where the corporation's scheduled indebtedness exceeds \$3,000,000.

<sup>30</sup> 11 U.S.C. § 571 (1970).

<sup>31</sup> 11 U.S.C. §§ 574, 616 (1970). "Fair and equitable" are words of art which were used in § 77B and had acquired a fixed meaning through judicial interpretations prior to the enactment of Chapter X. *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 115 (1939). The fixed meaning of the words was the absolute priority rule. That is, a plan is not "fair and equitable" unless it provides participation for claims and interests in complete recognition of their strict priorities, and unless the value of the debtor's assets supports the extent of participation afforded each class of claims or interests included in the plan. Any arrangement by which a junior class receives values allocable to a senior class [violates the rule].

6A COLLIER at 613.

The feasibility test in Chapter X tests the economic soundness and the practical viability of the plan. It encompasses such things as whether all the stipulations of the plan can be carried out, the adequacy of the capital structure, the ability of management to carry out the plan, the sufficiency of the earning power of the entity to meet its obligations, etc. 6A COLLIER at 637-644.

<sup>32</sup> 11 U.S.C. § 575 (1970).

<sup>33</sup> 11 U.S.C. § 576 (1970).

<sup>34</sup> 11 U.S.C. §§ 616(7)-(8) (1970).

<sup>35</sup> 11 U.S.C. § 732 (1970); FED. BANK. R. 11-18(b). Prior to the rules the referee had more

ness.<sup>36</sup> The debtor formulates a plan of arrangement which may modify only the right of unsecured creditors.<sup>37</sup> The debtor then solicits acceptances and after a majority of creditors in number and dollar amount accept the plan the court holds a hearing on the plan. The court then confirms the plan if it was proposed and accepted in good faith, is in the best interest of creditors, and is feasible.<sup>38</sup> Upon confirmation, the plan may be consummated. The entire proceeding is viewed as largely a private affair between the debtor and its unsecured creditors with the SEC having little or no participation.

Despite the intent of Congress, today most corporate debtors including large publicly held debtors ignore the costly, time consuming process of Chapter X. Because of its speed and flexibility and because specialists in the area have been able to overcome the two chief limitations of Chapter XI—the inability to affect secured creditors and equity security interests—Chapter XI has become “the dominant reorganization vehicle.”<sup>39</sup>

### 3. Sections 264 and 393

Both Chapter X and Chapter XI contain specific exemptions from registration for securities issued in either a reorganization or an arrangement. Section 264 of Chapter X states:

- a. The provisions of section 77e of Title 15 [Section 5 of the Securities Act of 1933] shall not apply to—

. . . .

- (2) Any transaction in any security issued pursuant to a plan in exchange for securities of or claims against the debtor or

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discretion to appoint a receiver. Whether the debtor was continued in possession or displaced by a receiver depended largely on local practice. *See Hertzberg, A Survey of Chapter XI with a Side Trip Through Chapter X*, 77 COM. L. J. 86 (1972).

<sup>36</sup> 11 U.S.C. § 743 (1970); FED. BANK. R. 11-23, 11-30, 11-45.

<sup>37</sup> 11 U.S.C. § 756 (1970).

<sup>38</sup> 11 U.S.C. § 766 (1970). Good faith in the Chapter XI context depends entirely on the circumstances and cannot practically be comprehensively defined. “Broadly speaking, the basic inquiry should be whether or not under the circumstances of the case there has been an abuse of the provisions, purpose or spirit of Chapter XI in the proposal or acceptance of the arrangement.” 9 COLLIER at 318.

The feasibility requirement of Chapter XI tests “whether the things which are to be done after confirmation can be done as a practical matter under the facts.” 9 COLLIER at 287. It is very close to the feasibility requirement of Chapter X (*see* note 31 *supra*), but is generally understood to be less stringent because of the different purposes of Chapter XI.

The “best interests of creditors” test is limited almost entirely to an inquiry into whether the creditors would receive more under the Chapter X arrangement than what they would receive in a liquidation proceeding. If they would receive more under the arrangement the plan meets the test. *See generally* 9 COLLIER at 380-85.

<sup>39</sup> COMMISSION REPORT, Part I at 244.



partly in such exchange and partly for cash and/or property. . . .<sup>40</sup>

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Section 393(a)(2) of Chapter XI, insofar as it is relevant here, reads the same way but omits the words "securities of or"<sup>41</sup> and substitutes "pursuant to an arrangement" for "pursuant to a plan".<sup>42</sup> Thus although the two chapters contain radically different methods for dealing with financially distressed businesses and different degrees of protection for creditors and equity holders, the exemptions from registration are identical. They are based on the same criteria and have the same limitations.

Exactly why the two sections are identical and, more fundamentally, why they were even included in the Bankruptcy Act in view of the § 3(a)(10) exemption in the Securities Act is not at all clear. The legislative analysis of the section states only that:

Section 264 is derived in part from section 77B(h). Under this provision no registration in compliance with the Securities Act of 1933 is required for the issuance of securities to the security holders or creditors of the debtor in whole or part exchange for their old securities or claims. However, new issues sold by the reorganized company for cash are required to be registered under the Securities Act just as any other new issues of securities, in order that prospective investors may have all material information before buying. Furthermore, the exemption for the issuance of securities to security holders and creditors under the plan does not extend to any subsequent redistribution of such securities by the issuer or an underwriter; for any such redistribution is subject to the same need for public disclosure of relevant data as in the case of a new issue.<sup>43</sup>

It seems odd that no reference was made to § 3(a)(10) or even to the ultimate policy reasons for the two exemptions. It should be noted, however, that Congress specifically did not base the exemption on any intrinsic fairness of securities issued in judicially supervised

<sup>40</sup> 11 U.S.C. § 664 (1970).

<sup>41</sup> As originally enacted § 393 did contain the words "securities of or." The words were deleted by a 1962 amendment. Act of Sept. 25, 1962, Pub. L. No. 87-681, § 16, 76 Stat. 570 (1962), *amending* 11 U.S.C. § 793(a)(2) (1970). The amendment was urged by the SEC. Since Chapter XI cannot affect the rights of either secured creditors or equity holders it was impossible to have a valid Chapter XI plan of arrangement providing for the issuance of securities in exchange for present "securities of" the debtor. Thus the words were of no effect. Apparently the problem arose since the drafters copied § 393 verbatim from § 264. *See* 9 COLLIER at 657-58.

<sup>42</sup> 11 U.S.C. § 793 (1970). Throughout the remainder of this paper §§ 264(a)(2) and 393(a)(2) will be referred to only as §§ 264 and 393.

<sup>43</sup> S. REP. No. 1916, 75th Cong., 3d Sess. 38-39 (1938). The House Report on the bill contained the only reference to § 393.

proceedings. Had the exemption been based on fairness alone, Congress would not have drawn the distinction between securities issued wholly or partly in exchange for claims and securities issued in the same proceeding, subject to the same scrutiny, but wholly in exchange for cash. Thus by merely examining the various statutory exemptions and their respective legislative histories it is clear that the three exemptions are not based on the same premise.

## II. OPERATION OF THE THREE EXEMPTIONS IN THE REORGANIZATION-ARRANGEMENT CONTEXT

In order to evaluate properly the functioning of the three exemptions, it is important to note their similarities and limitations. It is clear that the operation of the § 3(a)(10) exemption is premised upon the presence of three necessary elements:

- 1) the securities to be issued must be issued wholly or partly in exchange for present securities or claims of the debtor (the exchange requirement);
- 2) all persons who are entitled to receive the securities must have notice<sup>44</sup> of the required hearing and an opportunity to be heard (the participation requirement); and
- 3) the court must approve the securities only after holding a hearing on the fairness of the terms and conditions of the securities to be issued (the fairness hearing requirement).<sup>45</sup>

While most of the discussions of § 3(a)(10) are concerned with issues other than those involved in the reorganization context,<sup>46</sup> the most difficult theoretical questions involve determining the parameters of the three basic requirements in reorganizations, how these requirements relate to the requirements of §§ 264 and 393, and whether § 3(a)(10) is an independent basis for exemption for securities issued in Chapters X and XI.

### A. *The Exchange Requirement*

#### 1. Non-debtor Issuers

The exchange requirement is also a part of §§ 264 and 393.

<sup>44</sup> Notice is not a statutory requirement directly. However it was specifically required by the SEC shortly after the act passed. See Securities Act Release No. 312 (March 15, 1935).

<sup>45</sup> See generally, 1 Loss, at 584-591; 4 Loss (Supp.) at 2597-2600; BLOOMENTHAL, SECURITIES AND FEDERAL CORPORATE LAW, § 4.14 (1974) [hereinafter cited as BLOOMENTHAL].

<sup>46</sup> See, e.g., 1 CCH FED. SEC. L. REP. ¶¶ 2171-2245.27 (1975); Glickman, *The State Administrative Fairness Hearing and Section 3(a)(10) of the Securities Act—Some Questions*, 45 ST. JOHN'S L. R. 644 (1971) [hereinafter cited as Glickman] and the authorities cited in note 45 *supra*.

Unlike § 3(a)(10) which requires only that the security be issued "in exchange for outstanding securities, claims, or property interests,"<sup>47</sup> the exemptions in the Bankruptcy Act require that the securities be issued pursuant to a plan or arrangement "in exchange for claims against the debtor."<sup>48</sup> The exchange requirement raises two general problems. The first problem presented relates to identifying the offeror—i.e., can the issuer be a third party rather than the debtor itself. Here the § 3(a)(10) legislative history is helpful. As previously noted, the section was intended to apply "even though the original issuer of the securities, debtor on the claims, or owner of the property in which the interests are held, is not itself in the process of a reorganization."<sup>49</sup> This history has lead one noted commentator to state flatly that "there is no requirement of identity of the issuers."<sup>50</sup> There are no contrary cases or administrative rulings and the issue seems settled.

Chapter X and § 264 are slightly different. It is clear that Chapter X plainly contemplates the possibility that a new corporation would be formed or that a totally independent third party would participate in the proceedings and consolidate or merge the debtor into it.<sup>51</sup> Whether the exemption is available for securities of a totally independent third party issued in exchange for claims against a debtor is far less clear. Collier can be read as taking the position that the exemption is available, although no authority is cited for this position.<sup>52</sup> Other commentators point to certain cases in which, they argue, the SEC has implicitly recognized the exemption in this context.<sup>53</sup>

Chapter XI non-debtor issuers present more difficult problems. Collier takes the position that the exemption is available,<sup>54</sup> but fails to take note of the vast differences between the protection-laden provisions of Chapter X and the summary provisions of Chapter XI. Based on these differences, and differences discussed below relating to the fairness hearing, an impressive theoretical argument can be

<sup>47</sup> 15 U.S.C. § 77c(a)(10) (1970).

<sup>48</sup> 11 U.S.C. §§ 664, 793 (1970).

<sup>49</sup> H. R. REP. NO. 1838, note 10 *supra*.

<sup>50</sup> 1 Loss at 585.

<sup>51</sup> See 11 U.S.C. § 616(10) (1970).

<sup>52</sup> 9 COLLIER, at 658-59. Collier actually is silent on the reach of § 264 in this context. The statement is made in the context of Chapter XI and § 393 and thus *a fortiori* should apply to Chapter X.

<sup>53</sup> Corotto, *Debtor Relief Proceedings Under the Bankruptcy Act and the Securities Act of 1933—The Registration Requirement and its Implications*, 25 HASTINGS L. J. 389, 396-97 (1974) [hereinafter cited as Corotto].

<sup>54</sup> See note 49 *supra*.

made that the § 393 exemption should not apply to the non-debtor issuer in Chapter XI.<sup>55</sup>

Two recent no-action letters reveal that the SEC has taken a far more practical approach to the problem. In a letter involving Media Creation, Ltd., the SEC stated that § 393 "relates only to the securities of the debtor itself."<sup>56</sup> However, the letter went on to note that several factors merited special consideration including the facts that the stock was registered under § 12(g) of the Securities Exchange Act of 1934,<sup>57</sup> that the securities were to be issued to a small number of people, and that they would bear a restrictive legend. Because of these special factors no action was recommended by the Commission.<sup>58</sup> A similar approach was taken in a more recent letter. There the SEC waived slightly by stating that the availability of the exemption to a Chapter XI non-debtor issuer was an issue "not free of doubt."<sup>59</sup> In that transaction the SEC noted that the securities were used for the acquisition of a bona fide business operation, contained a restrictive legend, and that holders of the securities would cause the company to become a reporting company under § 12(g). However, on those facts the SEC was unwilling to give a no-action response.<sup>60</sup> The distinguishing factor seems to be the *present* availability of information about the securities. Stock presently registered under § 12(g) may be exempt, but stock to be registered under § 12(g) in the future will not.<sup>61</sup>

A similar ad hoc approach to the availability of the exemption can be seen in an unreported case involving Transystems, Inc.,<sup>62</sup> in which the SEC urged that § 393 must be interpreted "in the light of the statutory policy [of Chapter XI], and that the exemption *does not necessarily* extend to [non-debtor issuers]."<sup>63</sup> The Commission argued that when faced with close questions, the pivotal factor before the court should be whether the Commission will take future action. Exactly what criteria would be used to determine the SEC position in such close cases were not revealed, but the amount of information

<sup>55</sup> See Corotto, *supra* note 53, at 397-403.

<sup>56</sup> SEC No Action Letter, Media Creation, Ltd., April 30, 1972.

<sup>57</sup> 15 U.S.C. § 78(g) (1970).

<sup>58</sup> SEC No. Action Letter, Media Creation, Ltd., April 30, 1972.

<sup>59</sup> SEC No Action Letter, Data Graph, Inc., October 26, 1973.

<sup>60</sup> *Id.*

<sup>61</sup> The use of registration under § 12(g) as a determinative factor is not unique to this issue. See 38 SEC ANN. REP. 126 (1972), where the Commission reports that it withdrew its objections to a plan of arrangement under Chapter XI when the debtor registered voluntarily under § 12(g).

<sup>62</sup> Discussed in 37 SEC ANN. REP. 199 (1971).

<sup>63</sup> *Id.* (emphasis supplied).

presently available seemed to be a key point.

At this point it should be noted that the ad hoc, "sometimes" approach in these and other cases<sup>64</sup> is a direct result of the conflict between the approach of the 1933 Securities Act mandating disclosure and the statutory framework of Chapter XI which does not require such disclosure. Any imposition of a requirement of disclosure—or a requirement of a minimum amount of information publicly available—as a prerequisite for the § 393 exemption cannot be based on the provisions of Chapter XI.

## 2. The Value Exchanged

The other issue raised by the exchange requirement relates to what the offeree must give up. All three exemptions contain similar wording requiring the exchange to be at least partially for outstanding securities, claims, or property interests.<sup>65</sup> Thus, stock issued wholly in exchange for cash (or some other type of new consideration) is not exempt from the registration provision.<sup>66</sup> Exactly when a security is wholly worthless so that the exchange of the security plus cash for new securities is equivalent to an exchange wholly for cash can raise some difficult factual issues. Presumably, in a Chapter X proceeding, any time the corporation is insolvent in the bankruptcy sense, any exchange by its equity holders of their stock plus cash in exchange for new stock would not be exempt.<sup>67</sup> The potential for abuse of the exemption absent a strict enforcement of the exchange requirement is clear.<sup>68</sup> This abuse is not limited to Chapter X proceedings. On one occasion the SEC intervened in a Chapter XI pro-

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<sup>64</sup> See also the two cases cited in 37 SEC ANN. REP. at 201 (1971) where the SEC recognized the issue, but chose to side-step it by stressing certain deceptive practices rather than the exemption itself.

<sup>65</sup> It should be noted here that since Chapter XI proceedings can affect unsecured creditors only (note 37 *supra*), the exemption in Chapter XI would not reach an exchange for a secured claim or for stock.

<sup>66</sup> SEC v. Century Inv. Transfer Corp., [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,232 (S.D.N.Y. 1971).

<sup>67</sup> But see 4 Loss (Supp. 1969) at 2599 where Loss quotes a case as holding that [the insolvency of] a Chapter X debtor does not 'as a matter of law render the debtor's shares of stock valueless or deprive such shares of legal significance' so as to destroy the exemption for new securities issued in consideration of the shares and cash.

In the Matter of Bettinger Corp., No. 1019-60, (D. Mass., filed Oct. 31, 1961), *aff'd on other grounds sub nom.*, SEC v. Bloomberg, 299 F.2d 315 (1st Cir. 1962).

<sup>68</sup> In SEC v. Bloomberg, the court in dealing with the exchange of the worthless stock of insolvent corporations plus cash for new stock, stated: "One of the chief reasons they amended the proceedings from an arrangement under Chapter XI to a reorganization under Chapter X was to gain the exemption from registration." 299 F.2d at 319. Because of certain procedural problems the alleged scheme may have worked.

ceeding to stop the use of the proceeding by promoters "to manufacture 'free' stock for themselves by putting assets into a dormant corporation that happens to have wound up in Chapter XI."<sup>69</sup> The Chapter XI exemption has also been used as part of a scheme to pass the losses of creditors to the public by arranging to sell the securities issued to the creditors to the public without registration.<sup>70</sup>

Another aspect of this issue is the uncertainty of when a creditor must acquire his claim against the debtor in order to meet the exchange requirement. In other words, can those acquiring claims against the debtor during the Chapter X or XI proceedings (*i.e.*, the trustee, counsel, new creditors, etc.) exchange their claims for securities without registration? Section 3(a)(10) refers to "outstanding claims" while §§ 264 and 393 refer only to "claims." The SEC's "historic position" has been that post-petition creditors do not have exchangeable claims within the meaning of §§ 264 and 393.<sup>71</sup> There does not appear to be any case directly on point.<sup>72</sup> While the question is not free from doubt it is difficult to understand why the time at which the debt accrued (assuming it is a bona fide debt) should have any significant effect on the availability of the exemption. While the priority which these post-petition creditors receive in Chapter X and Chapter XI proceedings adequately protects them, there is no good reason why these creditors cannot choose to forego the protections and take their payment in stock of the reorganized company. To the extent that the SEC's position is based on provisions of Chapters X and XI other than §§ 264 and 393, or the historical practice of paying these post-petition creditors in cash, perhaps a different result would occur under § 3(a)(10).<sup>73</sup> The point is primarily theoretical since in most cases the private offering exemption under § 4(2) of the Securities Act<sup>74</sup> would be available.

It should also be noted that the exchange requirement is not an absolute bar to the influx of new money, even new money representing an equity interest, in reorganization proceedings, since the reorganization context is the type of situation which can fit neatly into the private offering exemption of § 4(2). If § 4(2) and rule 146<sup>75</sup> are fully

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<sup>69</sup> 36 SEC ANN. REP. 198 (1970), where an unreported case involving Realsite, Inc. is discussed.

<sup>70</sup> See SEC v. Granco Products, Inc. 236 F. Supp. 968 (S.D.N.Y. 1964).

<sup>71</sup> See the Commission's discussion of an unreported case involving Realsite, Inc., 36 SEC ANN. REP. 198 (1970).

<sup>72</sup> See *In re Jade Oil & Gas Co.* discussed in Corotto, *supra* note 53, at 405 n.78 in which the issue was raised but not resolved.

<sup>73</sup> *Id.*

<sup>74</sup> 15 U.S.C. § 77d(2) (1970).

<sup>75</sup> Rule 146, 17 C.F.R. § 230.146.

complied with, the initial issuance of stock would be exempt. While it is impossible to know how extensively the § 4(2) exemption is used in this context, it is quite apparent that its use is established and accepted.<sup>76</sup>

### B. *The Participation Requirement*

As previously noted, § 3(a)(10) requires that the hearing must be one "at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear. . . ."<sup>77</sup> Implicit in this right to appear is the right to have notice of the hearing.<sup>78</sup> What type of notice is adequate varies with the facts and circumstances of each case. Presumably the notice and participation requirements would not present any questions more difficult than similar requirements in ordinary civil litigation. There are few court decisions in this area other than those which hold the exemption not present where there has been no hearing.<sup>79</sup>

Sections 264 and 393 do not expressly contain a full participation requirement. However, the purpose of the participation requirement is to establish a fair procedural mechanism for placing the court's approval on the securities and both Chapter X and Chapter XI have similar safeguards. In Chapter X proceedings, all interested parties receive notice and have the right to participate both in the hearing before the solicitation of acceptances and the hearing after such solicitation. At both of these hearings the court approves the plan.<sup>80</sup> In Chapter XI proceedings the requirements are far less stringent, but still impose similar notice and participation requirements. In addition to a general notice section,<sup>81</sup> there are requirements that creditors receive notice of and have the right to participate in any meeting at which a plan of arrangement could be confirmed.<sup>82</sup> Thus although §§ 264 and 393 do not contain express participation requirements like that contained in § 3(a)(10) such specific requirements are unnecessary in view of the other sections of Chapters X and XI.

### C. *The Fairness Hearing*

The chief difference between § 3(a)(10) and the bankruptcy ex-

<sup>76</sup> See, e.g., 36 SEC ANN. REP. 198 (1970).

<sup>77</sup> 15 U.S.C. § 77c(a)(10) (1970).

<sup>78</sup> SEC Securities Act Rel. No. 312 (March 15, 1935).

<sup>79</sup> See, e.g., *Merger Mines Corp. v. Grismer*, 137 F.2d 335 (9th Cir. 1943).

<sup>80</sup> 11 U.S.C. §§ 569, 571, 579 (1970).

<sup>81</sup> 11 U.S.C. § 715 (1970).

<sup>82</sup> 11 U.S.C. §§ 735, 736 (1970); FED. BANK. R. 11-24.

emptions is that § 3(a)(10) by its terms requires a hearing on the fairness of the terms and conditions of the securities before the exempt exchange can occur, while §§ 264 and 393 require only that the exchange be pursuant to a plan or arrangement.<sup>83</sup> The absence of a fairness hearing requirement creates a void which, unlike the participation requirement, is only partially filled by other sections of Chapters X and XI. It is imperative in this context to distinguish Chapter X from Chapter XI. Among the many protections built into Chapter X is the requirement that the court find that the plan is "fair and equitable and feasible."<sup>84</sup> On at least two separate occasions the court must make this finding,<sup>85</sup> and the plan must be fair and equitable for *all* interested parties and not only for accepting parties.<sup>86</sup> Thus, while the directly mandated judicial supervision of the fairness of the terms and conditions of the securities is not present in Chapter X, there must be judicial approval of the fairness of the plan in its entirety, and if the issuance of securities is part of the plan, presumably the court must find that that part of the plan is fair also. Chapter XI, however, is entirely different. As previously noted, the provisions of Chapter XI sacrifice the protections of Chapter X for more speedy and economical, but more limited relief. The major restriction upon Chapter XI plans is the more limited "best interest of creditors" test.<sup>87</sup> Fairness, either to the creditors or to the public at large, is not the statutory standard. Arguably this distinction between Chapter X and Chapter XI plans places Chapter XI on an entirely different theoretical basis from Chapter X plans and from the requirement of § 3(a)(10). Efforts to reconcile these three sections and to close the loophole in Chapter XI created by the lack of qualitative standards have resulted in several problems.

### 1. Judicial Scrutiny

Even under § 77B reorganizations, some courts noted the problem or reconciling the fairness test of § 3(a)(10) with what seemed a more limited test in the reorganization context. Since the "fair and

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<sup>83</sup> It should be noted that these sections may in rare situations cause a question of exactly when the exemption arises. The SEC's position with regard to both § 3(a)(10) and the bankruptcy exemptions has been that the entire process of confirmation must be completed before the securities may be issued. Thus for example, in the Chapter X context, no securities may be issued until final confirmation under § 221. See SEC Securities Act Rel. No. 3000 (June 7, 1944).

<sup>84</sup> 11 U.S.C. §§ 574, 616 (1970). See note 31 *supra*.

<sup>85</sup> 11 U.S.C. §§ 574, 579 (1970).

<sup>86</sup> 11 U.S.C. § 616(7)-(8) (1970) (emphasis supplied).

<sup>87</sup> 11 U.S.C. § 766 (1970). See note 38 *supra*.



equitable" test was largely limited to the absolute (or at least relative) priority rule even at this early date,<sup>88</sup> the court which first recognized this problem attempted to reconcile the Bankruptcy and Securities Acts by interpreting the word "feasible." The court in *In re American Department Stores Corp.*<sup>89</sup> noted:

It is the duty of the court to pass upon the feasibility of the plan of reorganization. Although the plan were unopposed, the court should not approve any feature fundamentally unsound. Especially when . . . [the] securities when issued may be sold to the public. Congress in subdivision (h) of section 77B . . . provided that: 'All securities issued pursuant to any plan of reorganization confirmed by the court . . . shall be exempt from all the provisions of the Securities Act.' This imposes upon the courts the task of scrutinizing with care securities to be issued under a plan of reorganization.<sup>90</sup>

Without noting the inapplicability of the Chapters X and XI exemptions to subsequent resales to the public,<sup>91</sup> a fact upon which the *American Department Stores* court seemed to rely heavily, this language was picked up and relied upon in a Chapter X proceeding. In *In re Barlum Realty Co.*,<sup>92</sup> the court stated:

Since securities issued pursuant to a plan or [sic] reorganization under Chapter X are exempt from the registration requirements of the Securities Act. . . , there is a certain burden thrust on the Court to carefully scrutinize the proposed new securities and to reject any plan of reorganization which proposes to issue securities of an unsound type. [quoting the above language from *American Department Stores*.]<sup>93</sup>

The SEC has cited this position a few times in its Chapter X reports in analyzing the feasibility of various plans, but it has not emphasized the position at all. Even when the SEC has cited the position, it has relegated the argument to a footnote.<sup>94</sup>

From these two cases and the oblique references by the SEC, the leading commentators in the area have drawn a general rule that both

<sup>88</sup> *Northern Pacific Ry. Co. v. Boyd*, 228 U.S. 482 (1913).

<sup>89</sup> *In re American Dep't Stores Corp.*, 16 F. Supp. 977 (D. Del. 1936).

<sup>90</sup> *Id.* at 979-980.

<sup>91</sup> See the specific reference to the resale issue in the text accompanying note 43 *supra*. The language of old § 77B(h) treated such resales as exempt. See text accompanying note 17 *supra*.

<sup>92</sup> *In re Barlum Realty Co.*, 62 F. Supp. 81, (E.D. Mich. 1945), *aff'd*, 154 F.2d 562 (6th Cir. 1946).

<sup>93</sup> 62 F.Supp. at 88.

<sup>94</sup> See *Indiana Limestone Corp.*, 18 SEC 178, 196-7 n.28 (1945); *Green River Steel Corp.*, 37 SEC 507, 526, n.18 (1957).

Chapter X and Chapter XI courts have a duty to supervise closely the fairness of the securities issued.<sup>95</sup> It has been argued that such judicial scrutiny is "indispensable" in both Chapters X and XI.<sup>96</sup>

There are two major problems with this approach. First, it should be noted that no court has ever established an independent statutory basis for this requirement. Although the statement is made by courts, there is no statutory authority for imposing this added duty on the court. Any security which is part of a plan which otherwise complies with the statute should be exempt from registration regardless of any intrinsic fairness of the securities.

The second problem is that even assuming that such a duty is required of a Chapter X court (based on fairness rather than feasibility), there is little ground for extending this duty to Chapter XI proceedings. There is clearly a different and lesser approval standard in Chapter XI. The "best interests of the creditors" test and the "good faith" test do not really address themselves to the fairness of the securities. One can easily imagine a situation where both these tests are met, but the securities are less than fair, especially since it may be in the creditors' interest to pass the stock off to the public and realize a gain in this manner. While such distribution may not be in the best interests of the public, it may comply with the "best interests" test, and, if there is a legitimate purpose for the action, it may also comply with the "good faith" test.

The SEC has argued on at least one occasion that the court-recognized duty of scrutiny under Chapter X and § 264 should be applied in Chapter XI under § 393. The SEC argued that "[t]o differentiate one section from the other for this purpose would be to draw a distinction without a difference. The words Congress used in the two sections are identical. And so are the pertinent policy considerations."<sup>97</sup> As a general statement, the SEC's argument is not persuasive. It is true that nearly the same words are used in the two exemptions, but the same *tests* were *not* used in the two chapters; Chapter XI has a less stringent test. To say that the policy considerations are the same does not advance analysis. As discussed below, the policy considerations and what minimum disclosures, quantum of fairness, etc., the chapters require is completely unclear. Moreover, much of the force is taken from the statement when the context in

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<sup>95</sup> 6A COLLIER at 1196; 11 H. REMINGTON, CORPORATE REORGANIZATION § 4582 at 348 (1961); 1 LOSS at 585; 4 LOSS (Supp. 1969) at 2599.

<sup>96</sup> Corotto, *supra* note 53, at 396.

<sup>97</sup> Letter from the SEC Division of Corporate Regulation to Referee James Yacos, regarding Meter Maid Industries, Inc., January 14, 1971, at 5-6 [Hereinafter cited as Meter Maid Letter].

which it was made is understood. The SEC asserted the position based on the Chapter XI good faith requirement. In the case in which the statement was made there was a genuine issue of good faith in that the debtor had "dissipated almost all of [its] assets and had ceased doing business in any real sense."<sup>98</sup> The debtor was eventually adjudicated bankrupt. The same basic facts are true of the other unreported Chapter XI cases on which the SEC relied.<sup>99</sup> The unique circumstances of those cases do not support a general duty of court scrutiny in Chapter XI cases. Absent a sham (*i.e.*, an "arrangement motivated primarily by stock market considerations rather than by any serious desires to rehabilitate a business")<sup>100</sup> there is nothing in the good faith test which imposes upon the courts a duty similar to that imposed by the fairness and feasibility tests of Chapter X.

## 2. Standards of fairness and disclosure

By the explicit terms of § 3(a)(10), the court may only approve the securities after a hearing on their "fairness." No such intrinsic fairness is directly required by § 264 or § 393. Assuming that the SEC and the commentators are right, and that there is some duty of supervision over the quality of the securities based on fairness, feasibility, best interests of creditors, good faith, or even general policy, the inquiry becomes what exactly is required?

Since all of these possible grounds for the court's duty go to the value of the securities it would seem that the best way to infuse some content into this amorphous duty of supervision would be to adopt the standard of fairness used in § 3(a)(10). The chief problem with this approach is that, after over forty years of experience with that section, no explicit definition of fairness exists. The word does not even carry any minimum content. The author has been unable to locate any reported cases on what is required by the term (as opposed to what is generally required to meet § 3(a)(10)). The SEC has issued over ninety public no-action letters in the last four years in which the fairness requirement of § 3(a)(10) is discussed. The requirement has been discussed in terms of state and federal court hearings, and state

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<sup>98</sup> 37 SEC ANN. REP. 202 (1971).

<sup>99</sup> The SEC cited three unreported cases in support of its argument. *Meter Maid* Letter at 6 n.3. In the first case, *United States Research Corp.*, the SEC intervened primarily because of the misleading material disseminated to creditors rather than any need to enforce the court's duty of scrutiny. 36 SEC ANN. REP. 197 (1970). In the second and third cases *Universal Topics, Inc.*, and *Studio Creative Crafts, Inc.*, both debtors had little if any business and it appeared that the proceedings were actually a sham. 37 SEC ANN. REP. 202-03 (1971). All three corporations were eventually adjudicated bankrupt.

<sup>100</sup> SEC ANNUAL REP. 203 (1971).

and federal administrative hearings and in none of the letters is there anything more than a paraphrase of the statutory requirement that the appropriate body must look to the terms and conditions of the securities. The leading commentators are equally unsatisfactory.<sup>101</sup>

Perhaps, since "fairness" is such an amorphous and subjective term, the lack of any substantive standards implicit in it should not be surprising. Ultimately the fairness of any security will depend on all the facts and circumstances surrounding its issuer and its issuance. It is far easier to observe these facts and circumstances than to articulate them and explain why they lead to the decision that the terms of the particular security are fair. On a theoretical level, however, at least three problem areas are worth noting in an effort to make the fairness standard more objective.

#### a. Suitability

Any fairness standard leads inevitably to the question of fairness for whom. A security which is fair for a wealthy doctor who can afford to take a high risk may not necessarily be equally fair for a widow who needs low-risk, income-producing securities. While the NASD<sup>102</sup> and SEACO<sup>103</sup> suitability rules are clearly inapplicable to the issuer of securities, the more basic question of suitability cannot be ignored in the Chapter X and Chapter XI context if fairness is truly the requirement.<sup>104</sup>

Securities are not fair and equitable in a vacuum. Who the potential recipient of the securities will be is a factor which bears consideration. In a slightly different context this has been a consideration in the courts' struggling with the parameters of the Chapter X absolute priority rule.<sup>105</sup> While the needs of trade and other creditors affected in a Chapter XI proceeding may tend to be more nearly uniform, the needs of equity holders in a Chapter X proceeding (assuming solvency) are apt to be as diverse as the needs of all equity holders in any corporation. This diversity points up the total impract-

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<sup>101</sup> 1 Loss at 584-59; 4 Loss (Supp.) at 2498-2600; and BLOOMENTHAL at § 4.14[3] all discuss the § 3(a)(10) exemption without saying what must be met or even what type of proof should be offered to show fairness.

<sup>102</sup> Art. III, § 2, NASD Rules of Fair Practice, CCH NASD MANUAL ¶ 2152.

<sup>103</sup> 17 C.F.R. § 240.15(e)(2).

<sup>104</sup> On the suitability doctrine in general see Cohen, *The Suitability Rule and Economic Theory*, 80 YALE L.J. 1604 (1971); Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 MINN. L. REV. 233 (1966); Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 DUKE L. J. 445; Levin and Evan, *Professionalism and the Stockbroker: Some Observations on the SEC Special Study*, 21 BUS. LAW. 337 (1966).

<sup>105</sup> See Consolidated Rock Products Co. v. DuBois, 312 U.S. 510 (1941).

icality of imposing a suitability requirement on an issuer, especially one in reorganization where the offerees are fairly fixed. This however does not detract from the strength of the argument that, theoretically, suitability is an aspect of fairness. To a certain extent some of the states have recognized this by imposing on certain securities the restriction that they may only be purchased by persons with income or net worth over a certain amount.<sup>106</sup> This is the position of the Midwest Securities Commissioners Association.<sup>107</sup> While this income minimum requirement is arguably not a true suitability standard, it does represent the acceptance that theoretically some concept of suitability is implicit in a fairness requirement.

b. Competence

As previously mentioned, the whole validity of the § 3(a)(10) exemption rests on the ability of the relevant body to judge the fairness of the security. This observation is equally true with all those who make a fairness determination. Thus in the reorganization context the relevant inquiry becomes whether the courts alone, or alternatively, the courts in conjunction with the SEC, are competent to judge fairness of any security.

There are several problems with placing the fairness determination in the hands of the courts alone. Initially it should be noted that, even assuming that all the men and women who make up the federal bench are qualified jurists,<sup>108</sup> they are by definition generalists with limited time to devote to the extensive supervision of the issuer needed to insure that the securities are indeed fair.<sup>109</sup> Also, the adversary context in which issues are raised and resolved in the federal courts inherently limits the courts. They do not have the investigative powers or experience necessary to make a full independent review of the matter. An early commentator on the subject of whether the courts or an administrative agency should make such a determination

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<sup>106</sup> See, e.g., 1 OHIO SEC. BULL. (November 4, 1973).

<sup>107</sup> See, e.g., Statement of Midwest Securities Commissioners, Statement of Policy Regarding Real Estate Programs, 1 CCH BLUE SKY L. REP. ¶ 4821 (1975).

<sup>108</sup> This is not to imply that all members of the federal bench have even an elementary notion of the securities laws, quite the opposite may be true. For example the referee in a case involving Greater Western Home Manufacturers, recently authorized the debtor to sell publicly certain securities in its possession without registration since there was "no practical need" for registration. Upon the SEC's rushing in and informing the court that the debtor was an underwriter within the meaning of the Securities Act and that "practical need" was legally irrelevant under the Act the referee vacated his order. 37 SEC ANN. REP. 201 (1971).

<sup>109</sup> See Comment, *Effect of Section 3(a)(10) of the Securities Act as a Source of Exemption for Securities Issued in Reorganizations*, 45 YALE L.J. 1050, 1075 (1936) [hereinafter cited as 45 YALE L.J.].

argued quite persuasively that only administrative agencies, and not the courts, are competent to judge the fairness of the terms and conditions of the issuance of securities.<sup>110</sup>

To a certain extent Congress must have agreed with this analysis since it provided the court with a qualified advisor, the SEC, to assist the court in reorganizations and arrangements carried out under court supervision.<sup>111</sup> In Chapter X proceedings the SEC plays a major role. The SEC may participate as one of the parties although it has no independent right of appeal from court orders.<sup>112</sup> In most cases the SEC must be kept informed and the court may not approve a plan unless the SEC has made its report or informed the court that it will not do so.<sup>113</sup> The SEC presents its views and recommendations on such matters as the qualifications and independence of trustees and their counsel, sales of properties and other assets, fee allowances to the various parties, including the trustees and their counsel, and other financial or legal matters. However, the most important role of the SEC in Chapter X proceedings is its assistance in the formulation of plans of reorganization in compliance with all the statutory restrictions.<sup>114</sup> It operates to protect the public interest and as a true "friend of the court."<sup>115</sup> In Chapter X the SEC has a broad role, "custom-tailored to meet the needs of reporting on management ineptitude or indiscretions."<sup>116</sup>

The SEC's role in Chapter XI proceedings is far less extensive. For the first two years of the Act it had no clearly defined role. However, in 1940 the Supreme Court held that the SEC had standing to apply to the court for a dismissal of the Chapter XI proceeding where the SEC believed that the case should have been brought under Chapter X.<sup>117</sup> The 1952 amendments codified this position by adding

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<sup>110</sup> 45 YALE L.J. 1075-76.

<sup>111</sup> 11 U.S.C. §§ 572, 608 (1970).

<sup>112</sup> 11 U.S.C. § 608 (1970).

<sup>113</sup> 11 U.S.C. §§ 572-575 (1970).

<sup>114</sup> On the role of the SEC in Chapter X proceedings in addition to those authorities directly quoted see generally Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U.L.Q. REV. 317 (1941) [hereinafter cited as Frank]; and Windle, *The Securities and Exchange Commission and Corporate Reorganizations Under Chapter X*, 34 REF. J. 37 (1960) [hereinafter cited as Windle].

<sup>115</sup> Herzog, *Reorganizations and Arrangements Under Chapter X and XI: Problems of Administration from the Standpoint of the Court*, 35 REF. J. 113, 116 (1961).

<sup>116</sup> Katskee, *The Calculus of Corporate Reorganization; Chapter X v. XI and the Role of the SEC Assessed*, 45 AM. BANKR. L.J. 171, 192 (1971) [hereinafter cited as Katskee].

<sup>117</sup> SEC v. United States Realty & Improvement Co., 310 U.S. 434 (1940). This was only the second case in which the SEC took the position that it had a right to make such a motion. The issue was side-stepped in an earlier case. 6 SEC ANN. REP. 55 n.1 (1940).

§ 328 to Chapter XI which expressly granted this right to the SEC.<sup>118</sup> A review of the annual reports of the period reveals that from 1940 to 1954 this right was seldom fully exercised. Beginning in 1955, in response to what it considered the "increasing frequency" of the abuse of Chapter XI by its use by debtors with widely held securities, the SEC began to intervene in more Chapter XI proceedings.<sup>119</sup> During the period from 1940 to 1970 the SEC confined its role largely to making the § 328 motion to transfer the proceedings to Chapter X.<sup>120</sup> This far more limited role still involved some administrative action since a full investigation of the debtor was often necessary in order to compile the information necessary to convince the court that the proceedings should be transferred to Chapter X.<sup>121</sup> During this period the SEC began to recognize that Chapter XI proceedings were being used to attempt to escape the various provisions of the securities statutes. Around 1970 the SEC began to intervene not only to make the § 328 transfer motion, but also to point out deceptive practices, misuse of securities exemptions, and other securities law violations.<sup>122</sup> Thus, although the SEC's role in Chapter XI proceedings is expanding, it is still far less significant than its role in Chapter X.

The extent to which the SEC participates in these proceedings greatly effects the competence of the court to judge the fairness of any security. There is no requirement in § 3(a)(10) that anyone except the parties directly in interest be accorded the right to participate in the fairness hearing. Indeed, absent leave of court, the SEC would

<sup>118</sup> 11 U.S.C. § 728 (1970). See also FED. BANK. R. 11-15.

<sup>119</sup> 21 SEC ANN. REP. 93 (1955).

<sup>120</sup> During this period (and up to the present) the SEC consistently explained its limited role in Chapter XI proceedings with the following statement:

Chapter XI of the Bankruptcy Act provides a procedure by which debtors can effect arrangements with respect to their unsecured debts under court supervision. Where a proceeding is brought under that chapter but the facts indicate that it should have been brought under Chapter X, Section 328 of Chapter XI authorizes the Commission or any other party in interest to make application to the court to dismiss the Chapter XI proceeding unless the debtor's petition is amended to comply with the requirements of Chapter X, or a creditor's petition under Chapter X is filed.

See, e.g., 35 SEC ANN. REP. 170-171 (1969).

<sup>121</sup> Katskee at 193-4.

<sup>122</sup> Since 1970 the SEC annual report has carried the following statement with minor variations in addition to the one quoted in note 120 *supra*:

Attempts are sometimes made to misuse Chapter XI so as to deprive investors of the protections which the Securities Act of 1933 and the Exchange Act of 1934 are designed to provide. In such cases the Commission's staff normally attempts to resolve the problem by informal negotiations. If this proves fruitless, the Commission intervenes in the Chapter XI proceeding to develop an adequate record and to direct the court's attention to the applicable provisions of the Federal securities laws and their bearing on the particular case.

See, e.g., 38 SEC ANN. REP. 126 (1970).

be hard pressed to demonstrate its standing in a pure § 3(a)(10) hearing. Since "the courts do not appear to be particularly well adapted to accomplish by direct supervision what the Securities Act was intended to achieve,"<sup>123</sup> and since administrative agencies with expertise, such as the SEC, appear to be "better suited to perform this function than the courts,"<sup>124</sup> the ability of the courts alone to exempt securities that are fair seems highly questionable. In the Chapter X context the court's ability is considerably enhanced by the participation of the SEC. However, such participation is not mandatory in all cases and may be declined even where mandated.<sup>125</sup> In a Chapter XI proceeding, participation by the SEC is totally within its discretion. Undoubtedly its participation in Chapter X proceedings, and to a greater extent, its participation in Chapter XI proceedings, is restricted by its limited resources and desire to eliminate other more blatant and less complex evils.<sup>126</sup> Thus there is considerable doubt as to whether the present Chapter X court, much less the present Chapter XI court, is competent to find the requisite fairness.

### c. Minimum Disclosure

Assuming that securities issued in reorganizations and arrangements must meet some standard of fairness, another question arises: how much, if any, financial disclosure is mandated by the fairness requirement? In other words, is it possible for a court to determine the fairness of the security unless the court is apprised of the requisite financial data? Obviously some disclosure must be made to the court. However, a court is essentially a passive body accustomed to deciding questions presented in an adversary setting rather than actively supervising an independent investigation. Thus, the issue is more appropriately characterized as how much information must the debtor provide the offerees of the securities and in what form must this information be provided so that the offerees may formulate a position on the fairness of the securities and present that position to the court.<sup>127</sup>

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<sup>123</sup> 45 YALE L.J. at 1075.

<sup>124</sup> *Id.*

<sup>125</sup> 11 U.S.C. §§ 572, 573 (1970).

<sup>126</sup> See Frank at 349 where he explains the SEC's self-imposed limitations in Chapter X proceedings.

The volume of reorganization litigation is great, and except in cases where appearance is made at the judge's request, the Commission, therefore seeks to enter those cases in which its facilities are most needed and will be most useful.

See also Windle at 38.

<sup>127</sup> The analysis ignores the impact of the antifraud rules as requiring a minimum of disclosure. See note 14 *supra*.



The decision which the court must make, that the securities issued meet some fairness requirement, is directly analogous to the duty imposed on several state blue sky administrators. Thus, the type and format of information which they require the issuer to furnish to them should provide some insight into what information should be brought out in Chapter X and Chapter XI proceedings. For example, under the Ohio blue sky law,<sup>128</sup> among other things, for those securities registered by qualification,<sup>129</sup> the Division of Securities must determine that "the proposed offer or disposal of securities is not on grossly unfair terms."<sup>130</sup> The Division requires a large amount of detailed financial information in order to make this determination. Among other things the application for registration must disclose the actual purpose and character of the business, the use of proceeds, the business experience of all directors and officers, the amount of securities they hold and compensation they earn, the identity of all beneficial owners of more than ten percent of the voting shares, a certified balance sheet and profit and loss statement for the last fiscal year along with unaudited ones for a period since then, and projected financial statements for the next five years covering cash flow, profit and loss, as well as full balance sheets.<sup>131</sup> With this information in hand, the Division begins to judge the fairness of the issue. This information may then be supplemented by additional disclosures as the situation requires. Similar information is required by other blue sky administrators who are charged with enforcing a fairness standard.<sup>132</sup>

It is clear that the fairness standard requires that some information be furnished to the court (and therefore to all interested parties) but, unlike the blue sky administrators, the court lacks specific disclosure guidelines. The advisory role of the SEC would appear to be helpful here. Jerome Frank in an article written when he was chairman of the SEC explained how the SEC viewed its role in assisting the Chapter X court in the court's fairness determinations by seeing to it that the court received certain information:

Our emphasis on the feasibility of the plan fits in with other duties

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<sup>128</sup> OHIO REV. CODE ANN. §§ 1707.01-.99 (Page 1964).

<sup>129</sup> Basically unless the security is exempt, (§ 1707.02) the transaction is exempt, (§ 1707.03) or the security qualifies as one that may be registered by description (§ 1707.06) it must be registered by qualification (§ 1707.09).

<sup>130</sup> OHIO REV. CODE ANN. § 1707.07 (Page 1964).

<sup>131</sup> Ohio Division of Securities Form 9.

<sup>132</sup> See, e.g., the practice under the California statute described in H. MARSH and R. VOLK, PRACTICE UNDER THE CALIFORNIA SECURITIES LAW, 8-1 to 8-92 (1944) and the forms included in volume 2, at A-2-12 to A-2-26.

of the Commission. . . . The absence, in the solicitation of acceptances to reorganization plans, of the registration statement and prospectus devices by which disclosure is made under the Securities Act is compensated only partially by provisions of Chapter X. . . . [N]either the Commission's report nor such other information [as is required by Chapter X] ordinarily contains information as adequate as is contained in a prospectus which complies with the Securities Act. . . . Since the basis of the exemption from registration is the assumption that the judge who approves and confirms the plan will provide the necessary supervision of the securities to safeguard investors, we feel that it is our duty to urge upon the court the necessity for appropriate labelling of securities, *for full and complete disclosure*, and for preventing the issuance of securities which are in themselves deceptive or patently unsound.<sup>133</sup>

Thus, early in its history the SEC seems to have taken the position that not just disclosure, but full disclosure, was an inseparable part of fairness. The value of disclosure in reorganizations was at least implicitly recognized by the Supreme Court when it quoted favorably from the Tenth Circuit *American Trailer Rentals* case. In discussing the plan, the court stated:

[I]f the stock involved here were not part of an arrangement, the disclosures made with regard to it would be clearly inadequate. No authority has been found which would indicate that recipients of stock issued in connection with an arrangement are not entitled to as much information as are those persons acquiring stock under ordinary conditions.<sup>134</sup>

In that case the Tenth Circuit had held that "If it appears, for the protection of those being solicited to accept the plan, additional information is necessary, the Court should so order."<sup>135</sup> Both courts implicitly recognized that the disclosures made in that case complied with the explicit disclosure provisions of the bankruptcy statute, but were inadequate for other reasons. These reasons must relate to some required minimum disclosure mandated by some fairness requirement.

Thus, the authorities indicate that some disclosure is necessary, but exactly how much is unclear. "Full and complete disclosure" equal to that available to persons "acquiring stock under ordinary circumstances" cannot realistically be read as requiring the full tech-

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<sup>133</sup> Frank at 346-47 (emphasis supplied).

<sup>134</sup> SEC v. American Trailer Rentals Co., 379 U.S. 594, 615-16 (1965) quoting 325 F.2d 47, 53 (10th Cir. 1963).

<sup>135</sup> *In re American Trailer Rentals Co.*, 325 F.2d 47, 53 (10th Cir. 1963) *rev'd on other grounds sub nom.*, SEC v. American Trailer Rentals Co., 379 U.S. 594 (1965).

nical equivalent to a standard registration statement. The purpose of financial disclosure is to educate the consumer so that he (either alone or with professional advice) may make an informed investment decision.<sup>136</sup> The particular use of such information in reorganizations and arrangements is only a variant of this. Hence, there should be enough basic financial information about the debtor and the debtor's future furnished to all the potential recipients of the securities to enable them to make an informed decision on whether or not to accept the plan. Compliance with registration-type technical details would only be counterproductive.<sup>137</sup>

It must be noted, however, that the informed investment decision in the reorganization context does not inevitably lead to the same result as an informed investment decision in a more normal investment context. Normally, the investment decision is an individual decision having immediate effects only on the individual. However, the decision made by those participating in Chapter X or Chapter XI proceeding is a group or class decision. Hence, it is not totally realistic to speak of an individual informed investment decision (to accept or reject a plan) since the individual will be bound by a two-thirds vote of his class in Chapter X and a majority vote of his class in Chapter XI. Therefore, an informed individual may be at the mercy of a class which chooses to make an uninformed or unwise decision. The fairness of this forced "investment decision" may certainly be questionable. This, however, is not a function of the securities policy mandating disclosure, but rather a result of the peculiarities of the bankruptcy procedure and does not detract from the general need for adequate disclosure.

Since such disclosure is a necessary element of the fairness standard, there should be specific statutory provisions for it. Chapter X contains a number of sections relevant to disclosure. The trustee is required to file a plan of reorganization or a report stating why no plan can be filed.<sup>138</sup> The SEC also usually files a report including its analysis of the plan.<sup>139</sup> After the plan is approved by the court as meeting the required standards, the plan and the SEC report, along with "such other matters as the judge may deem necessary or desirable for the information of creditors and stockholders,"<sup>140</sup> is mailed to

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<sup>136</sup> See generally Sommer, *Random Thoughts on Disclosure as "Consumer" Protection*, 27 BUS. LAW. 85 (1971).

<sup>137</sup> Indeed it would probably be impossible. See, e.g., Schneider, *Nits, Grits, and Soft Information in SEC Filings*, 121 U. PA. L. REV. 254 (1972). [hereinafter cited as Schneider].

<sup>138</sup> 11 U.S.C. §§ 567, 569 (1970).

<sup>139</sup> 11 U.S.C. § 572 (1970).

<sup>140</sup> 11 U.S.C. § 575 (1970).

all parties in interest. Only after the information is mailed may acceptances be solicited.<sup>141</sup>

These provisions in most cases would probably meet any disclosure standards imposed. The SEC investigation is thorough and results in a comprehensive report.<sup>142</sup> In some cases, the result is better than that which a potential investor would otherwise get. As a matter of course the SEC reports discuss valuation of the enterprise. The value of the enterprise and its future earning potential are perhaps the most critical factors of interest to potential investors, and it is just this information in this direct form which investors are denied by the normal registration statement.<sup>143</sup> The investor wants to know if the security is a "good buy" and that is exactly what the SEC report is designed to tell him. In some ways, the SEC report is a direct answer to the request of some commentators for limited recommendations on securities.<sup>144</sup>

The provisions of Chapter XI are far less conducive to adequate disclosure. If the SEC participates at all, it is on a far more limited basis. In almost all cases the debtor remains in possession, and thus the debtor has greater control over the flow of information. The arrangement process is essentially one of negotiation between the debtor and its major creditors. While there is a potential vehicle for disclosure to the creditors in the power of elected creditors' committees to examine the debtor's affairs, negotiate, and make reports to other creditors,<sup>145</sup> the extent to which these powers are exercised depends entirely on the creditors. There is no statutory requirement for an independent investigation, for any minimum disclosure or for any formal report to all creditors. In fact, acceptances of the debtor's plan may even be solicited *before* the first meeting of creditors and thus before formal creditors' committees can be elected to investigate the debtor.<sup>146</sup> Routinely, Chapter XI acceptances are solicited without judicial scrutiny over the methods used and information disclosed.<sup>147</sup> Plans are also often confirmed without full disclosure of the relevant financial data to the court.<sup>148</sup> This is undoubtedly due, at least in part,

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<sup>141</sup> 11 U.S.C. § 576 (1970).

<sup>142</sup> See Windle at 38, 39-41, Katskee at 192, and especially Frank at 335-36.

<sup>143</sup> See generally Schneider, and also Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151 (1970).

<sup>144</sup> Joslin, *Federal Securities Regulation from the Small Investors' Perspective*, 6 J. PUB. L. 219 (1957).

<sup>145</sup> 11 U.S.C. §§ 936(3), 939 (1970).

<sup>146</sup> 11 U.S.C. § 936(4) (1970).

<sup>147</sup> See *Transystems Inc.*, an unreported case cited in 37 SEC ANN. REP. 199 (1971) and quoted in Corotto, *supra* note 53, at 395 n.28.

<sup>148</sup> No less an authority than Louis Loss has speculated that "the court in approving a plan

to the lesser standards for confirmation of the plan used in Chapter XI.<sup>149</sup> This does not mean that the disclosure is any less a requirement in Chapter XI than in Chapter X, but only that it is being ignored. *American Trailer Rentals*, the only case in which a court of appeals recognized this duty of disclosure, was a Chapter XI case. Thus, although Chapter X meets the disclosure requirements, Chapter XI, both in theory and in practice, cannot measure up to the required disclosure standards.

d. The Use of § 3(a)(10) in Chapter X and Chapter XI.

The traditional approach to the use of § 3(a)(10) in Chapter X and Chapter XI proceedings has been that as long as its provisions could be met the exemption was available. The thought was often expressed that "[i]t is quite clear that the exemption of section 3(a)(10) covers the issuance of securities while the debtor is under the auspices of the court in X and XI."<sup>150</sup> However, in view of several current no-action letters this position is clearly contrary to that taken by the SEC. Thus, while the traditional position is not clearly wrong, it will no longer go uncontested.

Initially it must be decided what difference it makes if § 3(a)(10) is unavailable in Chapters X and XI. It makes little if any practical difference in Chapter X. A review of the material discussed above shows that, for most purposes, § 264 as interpreted requires everything that § 3(a)(10) requires. Compliance with both exemptions is achieved in the same manner. However the discussion above indicates that it may make a difference with Chapter XI proceedings. Despite the questionable authority to the contrary, compliance with the provisions of Chapter XI, especially § 393, does not automatically insure compliance with § 3(a)(10). Since Chapter XI is the "dominant reorganization vehicle," the question of the relevance of § 3(a)(10) in Chapter XI is more than academic.

Despite a number of early SEC administrative pronouncements that seemed to imply that § 393 and § 3(a)(10) were independent alternatives available to the Chapter XI debtor, that is clearly not the

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of arrangement may be thinking more about disposing of its docket than of the protection of investors." ALI PROPOSED FEDERAL SECURITIES CODE § 511(e), Comment 2 (1972).

<sup>149</sup> In *In re American Trailers Rentals* the court after holding that additional information should be disclosed noted that "It may be that even without the additional information, the arrangement would still be in the 'best interest of creditors' . . ." 325 F.2d at 53.

<sup>150</sup> Salter, *Exemption of Securities from Registration Issued Under Chapters X and XI*, 76 Com. L.J. 6, 8 (1971). See also 1 Loss at 584, 4 Loss (Supp.) at 2598; BLOOMENTHAL at 4-148 to 4-149; Corotto, *supra* note 53, generally, but see Corotto at 408.

present SEC position.<sup>151</sup> The SEC has stated that in its view § 3(a)(10) is

drawn in somewhat more general terms than the exemptive provisions incorporated in Section 393 of Chapter XI, because they would be applicable to a wide range of proceedings under various federal or state laws. But they apply essentially the same standards, in substantially the same language as Section 393. . . . We, therefore, regard Section 393 of the bankruptcy act as a *specific application* of the previously enacted Securities Act exemptions to the Chapter XI context, and conclude that, in Chapter XI proceedings, corresponding Securities Act exemptions must be construed to conform to the more specific terms of Section 393.<sup>152</sup>

In later no-action letters the SEC stated that § 3(a)(10) "was superseded by Section 393 in the Chapter XI context,"<sup>153</sup> and that "any failure to conform to the requirements of such proceedings cannot be cured by resort to another Act. A contrary construction would render Sections 264a and 393a superfluous and would nullify the particular limitations on their use as stated [in Chapters X and XI]." <sup>154</sup> This position has been restated several times recently and appears to be firmly entrenched.<sup>155</sup>

The SEC's "superseded by" and "specific application of" rationale are questionable on theoretical grounds. Surely there is nothing in the legislative history which would call for such a narrow interpretation. The drafters of § 3(a)(10) surely thought it would apply in the reorganization context since they made specific reference to it in the reports.<sup>156</sup> Also, §§ 264 and 293 were taken directly from the old § 77B(h) which predated the present version of § 3(a)(10).<sup>157</sup>

From a practical standpoint, it is difficult to see why the SEC has pushed this position in Chapter XI, especially in view of the fact that the fairness standard is explicit in § 3(a)(10) while only implicit, if existing at all, in Chapter XI. This is especially true in view of an easier, but more technical way of reaching the same result with Chapter XI proceedings. Section 3(a)(10) states that the securities are

<sup>151</sup> See, e.g., SEC No Action Letter, Seaferro, Inc., (March 23, 1971) [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,097; SEC Securities Release No. 3011 (August 28, 1944).

<sup>152</sup> SEC No Action Letter, Sequential Information Systems, Inc. (December 4, 1972). (emphasis supplied).

<sup>153</sup> SEC No Action Letter, Data Graph, Inc. (October 26, 1973) (emphasis supplied).

<sup>154</sup> SEC No Action Letter, O'Neill Bondholders Committee (June 17, 1974).

<sup>155</sup> See SEC No Action Letters, Arby's Inc. (March 1, 1974); Miller-Wohl Co. (August 30, 1973) and Transmagnetics, Inc. (May 21, 1973).

<sup>156</sup> See text accompanying notes 8-12 *supra*.

<sup>157</sup> See text accompanying notes 16, 43 *supra*.

exempt from registration if they are issued in exchange for other securities and claims, but only *after* the fairness hearing. Unlike Chapter X, in Chapter XI the acceptances to the plan are solicited *before* and as a condition precedent to the court's judgment that the plan meets all the requisite criteria. Since the solicitation of acceptances cannot be exempt from the registration provisions of § 5 until after the hearing, it is doubtful that the confirmation hearing of Chapter XI, which is the first time the court passes on the plan, could double as the fairness hearing.<sup>158</sup> Thus, a strong argument can be made that § 3(a)(10) should be unavailable in Chapter XI as a routine matter.

Perhaps the SEC feared that Chapter XI courts would conduct a separate non-statutory hearing to which all parties would have notice *before* acceptances were solicited. Technically this would seem to comply with § 3(a)(10). However, the SEC has taken the position that such a hearing would be *ultra vires* and therefore not within the exemption. In a straight bankruptcy case involving the sale of securities which otherwise would require registration,<sup>159</sup> the SEC stated its position that the § 3(a)(10) exemption was unavailable.

The Division is aware that Section 3(a)(10) does not require that a court, as distinguished from an administrative agency, be 'expressly authorized' to make such a [fairness] finding. But a court can act judicially only within its sphere of jurisdiction, and we remain of the view that a court of bankruptcy lacks jurisdiction to pass upon the terms and conditions upon which securities are to be issued by a purchaser at a bankruptcy sale. Consequently, it is our view that an order by a bankruptcy court cannot meet the requirements of Section 3(a)(10).<sup>160</sup>

The SEC's *ultra vires* doctrine cannot possibly be founded on any notion of judicial competence since the same court which supervises the issuances of securities in Chapter X (usually assisted by the SEC) and Chapter XI (usually unassisted by the SEC) would super-

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<sup>158</sup> See Corotto, *supra* note 53, at 408; See also SEC No Action Letter, Fidelity Finance Corp. (May 2, 1973) [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,840, where the SEC refused to recommend no action on the availability of § 3(a)(10) when a state Commission made what would otherwise be an adequate fairness determination after a merger was finalized but before it was complete and before any stock was issued.

<sup>159</sup> Although the facts of the situation are unclear a similar situation giving rise to the need for registration of securities before sale in a straight bankruptcy proceeding would occur whenever the debtor was a control person and the purchasers could not fit within any other exemption.

<sup>160</sup> SEC No Action Letter, O'Neill Bondholders Committee, Reconsideration (August 9, 1974). See also O'Neill Bondholders Committee (June 17, 1974).

vise their issuance in straight bankruptcy. Indeed, the SEC has recognized that state court judges (who may be totally unfamiliar with the federal securities law) can conduct the fairness hearing.<sup>161</sup> Rather, it is more likely that the SEC's concern is that permitting any court to hold the fairness hearing absent some statutory basis for it would open the door to potential abuses.

However, the SEC itself has been partially responsible for the growth of this potential abuse. In late 1971, the SEC issued a no-action letter stating that the issuance of stock to a class of shareholders in settlement of an action based on the Securities Act was exempt where the court held a hearing on the fairness of the proposed settlement.<sup>162</sup> Shortly thereafter a similar letter relating to stock warrants was issued.<sup>163</sup> In slightly over three years since then, the SEC has issued twenty-three such letters for similar federal class actions and derivative suits, most of them based on the Securities Acts. While the rationale for these letters is seldom discussed, the only possible way to distinguish the court's fairness hearing in these cases from a possible additional hearing in the Chapter XI context is the presence of Federal Rules of Civil Procedure 23(e) and 23.1.<sup>164</sup> Both of these rules impose upon the court a duty to approve all settlements.

Two things should be noted about the court settlement exception to the ultra vires doctrine. The court duty is imposed by a civil rule rather than by statute. If a civil rule is sufficient authority upon which to premise a fairness hearing, several questions arise. Would a local rule of court also be sufficient? If not, how can a local rule be distinguished from the federal rule? If so, what is left of the general ultra vires doctrine? These questions point up the potential breadth of this part of the § 3(a)(10) exemption.

More importantly for the reorganization context is that the rule itself does not require any independent verification of fairness. The criteria used for approving a court settlement may be far different than the criteria used for approving the fairness of securities. In approving a settlement, the court may be far less likely to impose its own judgment and may be more favorably inclined to the compro-

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<sup>161</sup> See SEC No Action Letter, *Black Steer of America, Inc.* (April 12, 1972).

<sup>162</sup> SEC No Action Letter, *VTR, Inc.* (October 8, 1971) [1971-72 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,518.

<sup>163</sup> SEC No Action Letter, *LIN Broadcasting Corp.* November 8, 1972) [1972-73 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,154.

<sup>164</sup> Federal Rule of Civil Procedure 23 relating to class actions reads in part:

(e) A class action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to all members of the class in such manner as the court directs.

Federal Rule 23.1 relating to derivative actions reads in the same manner.



mise which the parties have achieved.<sup>165</sup> However, it is just this independent judgment which the § 3(a)(10) exemption and any true fairness decision contemplates. It should also be noted that any approval of the securities to be issued in settlement will be made by the court alone and, as has already been noted, the competence of any court acting alone to make the fairness determination is subject to question. Some courts realizing this have requested the assistance of an already overburdened SEC in evaluating such settlements.<sup>166</sup>

This complex maze of SEC doctrine with § 3(a)(10) being superseded by § 393, the unavailability of § 3(a)(10) in ordinary bankruptcy, but availability in class action and derivative suits before the same district court judge is difficult to reconcile on theoretical grounds if fairness alone is considered. The one recurring note running through all of these variations on the § 3(a)(10) theme is that the SEC is primarily concerned with disclosure rather than fairness. Section 393 supersedes § 3(a)(10) not because its qualitative standards are more rigid (on the contrary they probably are weaker), but rather because the SEC believes that Chapter XI imposes greater practical disclosure standards than does § 3(a)(10). The ability of the court to supervise the fairness of the sale of securities in ordinary bankruptcy does not really differ from its ability to supervise the fairness of class action settlement, but the amount of disclosure probably does differ. In class action suits, especially those involving violations of the securities acts, there most probably has been extensive discovery and the offerees have discovered the information necessary to make an informed investment decision. The same amount of disclosure is less likely to come forward in the ordinary bankruptcy context.

It is submitted that the only way to understand the SEC's position in these various matters is to realize that fairness is an impossible goal. Its subjective nature does not easily translate into rules enforceable by courts. Disclosure, on the other hand, is a more objective goal and one with which the SEC has much experience. Thus even though fairness is the § 3(a)(10) standard, the SEC formulates its position by focusing on the amount of disclosure rather than any concept of fairness.

### III. RECOMMENDATIONS WITHIN THE PRESENT SECURITIES AND BANKRUPTCY ACTS

No less an authority than Louis Loss has stated that §§ 264 and

<sup>165</sup> On the court's practice in this area *see generally* 3B J. MOORE, *FEDERAL PRACTICE* ¶¶ 23,80[4], 23,124[2].

<sup>166</sup> *See* Norman v. McKee 290 F. Supp. 29 (N.D. Cal. 1968).

393 of the Bankruptcy Act "add nothing to section 3(a)(10)."<sup>167</sup> Other noted commentators have echoed this and have referred to the two bankruptcy sections as "express duplicative exemptions."<sup>168</sup> The one thing which the above analysis should make clear is that the three sections are not identical. They impose similar, but still distinct requirements. Their application has had different practical results. In Chapter X, the quality of the securities and the amount of disclosure must meet high standards. In Chapter XI, the quality standards are weaker. In Chapter XI, the disclosure standards are judicial rather than statutory, of recent origin, seldom really imposed and thus of little practical benefit. If there is a theoretical and practical loophole in the securities exemptions, it is in the distribution of large amounts of unregistered securities by the use of Chapter XI by corporate issuers. No amount of judicial action based upon SEC urging will totally fill this gap. Thus even assuming the retention of the present Bankruptcy and Securities Acts two major changes should be made.

First, § 3(a)(10) should be repealed. It serves no function in bankruptcy and its use in other contexts is questionable. Its use by state agencies has been infrequent<sup>169</sup> and criticized.<sup>170</sup> Its use in court settlements is of very recent origin and amounts to little more than a means to sidestep the requirements of rule 146. To the extent that it has any independent use, perhaps the exemption for insurance, banking and similar agencies should be retained. However, the need for exemption in those areas presents no justification for a broad exemption covering other situations. Tying the exemption to a fairness hearing is unrealistic. The concept of fairness is foreign to the federal securities statutes. It is an amorphous goal. Neither the SEC nor the courts have any practicable way of achieving it.

Second, the disclosure requirements of both Chapters X and XI need to be strengthened since judicial supervision is a questionable

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<sup>167</sup> 1 LOSS at 584, Loss's misunderstanding of Chapter XI can be easily understood. At the time of the first edition of his work on securities both Chapter X and Chapter XI contained fair and equitable standards. Because of this identical standard he thought the exemptions were equal, and his statement that § 264 and § 393 add nothing to § 3(a)(10) can be traced to his 1951 edition. LOSS, *SECURITIES REGULATION*, 369-70 (1951 ed.). This statement was carried forward in the 1961 edition even though the standards in Chapter XI had been changed. 1 LOSS at 584. It was not until the 1969 Supplement that any distinction was recognized and then the matter was left open. 4 LOSS (Supp.) at 2598. Unfortunately the analysis in the 1961 edition has been picked up and frequently cited.

<sup>168</sup> BLOOMENTHAL at 4-149 n.440.

<sup>169</sup> Only three states have statutes allowing such action: California, Oregon, and Ohio. CALIF. CORP. CODE § 25142 (West Supp. 1973); ORE. REV. STAT. § 59.095 (1974); OHIO REV. CODE ANN. § 1707.04 (Page 1964).

<sup>170</sup> See, e.g., Glickman at 648-55, 663-64.

substitute for administrative investigation. In those Chapter X cases in which the SEC chooses not to participate and in most Chapter XI cases there is no one to represent the public interest. The public may well be able to protect itself, but only if it has the requisite information. There are several ways this could be accomplished, two of which are discussed below.

The securities exemptions should be moved from the Bankruptcy Act and placed in the Securities Act under § 4, the exempt transactions section. Alternatively, they could be treated under a variant of § 3(b), but without the \$500,000 limitation.<sup>171</sup> Either of these amendments would have the advantage of putting the exemptions within the SEC's rule making power.<sup>172</sup> In such a posture the SEC could more efficiently regulate the issuance of reorganization securities. It could establish rules governing disclosure, setting minimum filing requirements, etc. The exemption would then be more flexible with the possibility of change as the situation demanded it. The use of the no-action letter policy would also be an advantage. Another possibility would be to require the debtor in all cases (both Chapters X and XI) to furnish certain minimum information to all interested parties before acceptances could be solicited. The availability of the information could be a criterion for approval. As a prerequisite to any confirmation the court would have to make as a specific finding of fact that adequate financial information was given to all parties. The adequacy of the information could be an appealable question thus bringing the issue sharply into focus before the appellate courts.

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<sup>171</sup> § 3(b), 11 U.S.C. § 77c(b) (1970) states that

The Commission may from time to time by its rules and regulations and subject to such terms and conditions as may be prescribed therein, add any class of securities to the securities exempted as provided in this section, if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering, but no issue of securities shall be exempted under this subsection where the aggregate amount at which such issue is offered to the public exceeds \$500,000.

If the SEC has power to exempt a whole class of securities it has power to exempt only a transaction in these securities. For a recent application of § 3(b) and this transactional exemption see rule 240, 17-C.F.R. 230.

<sup>172</sup> Of course the § 3(a)(10) exemption is presently within the SEC's rule-making power and the SEC could easily define fairness in terms of disclosure. This however, would have little effect in the reorganization context unless the SEC reversed its present position on the availability of § 3(a)(10) in Chapters X and XI. Even given the reversal any SEC rule could not deny the alternatives of § 364 or § 393, and thus, given the present statutory framework, the SEC's rule-making power does not effectively reach reorganization securities.

#### IV. THE PROPOSED SECURITIES CODE AND PROPOSED BANKRUPTCY ACT

##### A. *The Securities Code*

In the Proposed Federal Securities Code, the drafters have consolidated §§ 264 and 393 into a § 3(a)(10)-type exemption because in their opinion the bankruptcy exemptions "are largely but not altogether superfluous."<sup>173</sup> Proposed § 511(e) exempts any transaction incident to

(1) the issuance of a security to existing security holders or creditors of the issuer if (A) the issuance is pursuant to a plan of reorganization or an arrangement under section 77 or chapter X, XI, or XII of the Bankruptcy Act, or (B) the terms and conditions of the issuance are approved, after a hearing on their fairness at which all proposed offerees have the right to appear, by a court of competent jurisdiction, an official or agency of the United States, or a banking or insurance commission or other governmental authority of a State expressly authorized by law to grant such approval.<sup>174</sup>

The proposed section makes two basic changes in the present statute. The first change is that the present exchange requirement is eliminated. The object of the change was "to extend the exemption to the issuance of securities solely for cash but only to existing security holders or creditors of the issuer" because the present requirement "is without much logic."<sup>175</sup> Given the constraints of the absolute priority rule in Chapter X and the limits of Chapter XI the proposed change would not have a major theoretical impact. However, it should be noted that the only distinctions between the issuance of securities by any financially sound company for cash to its present creditors and shareholders which requires registration, and the same issuance by the same company when it is in Chapter X or XI which does not require registration is the presence of the judicial approval and whatever constraints the Bankruptcy Act contains. Thus, the exemption is based in part on the same questionable premise as are the present exemptions. This is even noted in the comments to the ALI proposal which state that the exemption was put in its proposed form even though "the court in approving a plan or arrangement may be thinking more of disposing of its docket than of the protection of investors."<sup>176</sup> It should also be noted that the proposal deletes any

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<sup>173</sup> ALI PROPOSED FEDERAL SECURITIES CODE § 511(e) Comment. (1972).

<sup>174</sup> *Id.* at § 511(e)(1).

<sup>175</sup> *Id.* at Comment 2.

<sup>176</sup> *Id.*

remnants of the fairness requirement in the bankruptcy context. Any restrictions on the issuance of reorganization securities must come from the Bankruptcy Act itself, not from the Securities Code. As argued above, this position does not permit the needed flexibility of SEC rule-making. Given the present Chapter XI standards and practice as outlined, it is questionable whether all securities issued in all Chapter XI proceedings should be exempt from registration.

### B. *The Proposed Bankruptcy Act*

Since the Proposed Securities Code shifts all the substantive restrictions from the securities acts to the bankruptcy acts it is quite appropriate to examine the major proposals of the Commission on the Bankruptcy Laws of the United States as they affect reorganizations.<sup>177</sup>

The proposal consolidates the present Chapters X and XI into a proposed Chapter VII with substantial duties being assigned to the proposed Federal Bankruptcy Administrator. As soon as is practical after the petition is filed, the administrator meets with the appointed creditors' committee or committees to decide if the business should be continued, if a trustee is necessary, and if so who it should be. A trustee need not be appointed in every case; the ultimate decision is made by the court.<sup>178</sup>

The plan, which may be proposed by the creditors' committee as well as by the administrator, may affect secured debt and equity interests as well as unsecured debt. The most important changes from present reorganization procedure are in § 7-303 of the proposed act relating to the requirements of the plan. The best interests test is discarded, but the absolute priority rule is retained in a much more "modified" form. Equity holders and management are given vastly increased participation rights.<sup>179</sup> In addition the plan may contain "cram-down" provisions similar to those now in use<sup>180</sup> and other

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<sup>177</sup> COMMISSION REPORT, Part, 1, 237-73, Part II §§ 7-101 to 7-715. [All citations to Part II will be by section number only]. For a more detailed description of the Commission's proposals as they effect reorganizations see King, *The Business Reorganization Chapter of the Proposed Bankruptcy Code—or Whatever Happened to Chapters X, XI, and XII*, 78 COM. L. J. 429 (1973) [hereinafter cited as King]; Trost, *Corporate Reorganizations under Chapter VII of the "Bankruptcy Act of 1973": Another View*, 48 AM. BANKR. L.J. 111 (1974); King and Rosen, *An Introduction to the Proposed Bankruptcy Act of 1973*, 79 COM. L.J. 472 (1974).

<sup>178</sup> § 7-102(a). In all cases where the debtor is a corporation with debts of \$1,000,000 or 300 security holders, the administrator must apply for the trustee's appointment. The court must then appoint a trustee unless the protection afforded by a trustee is unnecessary or the expense disproportionate to the protection.

<sup>179</sup> § 7-303(3)-(4).

<sup>180</sup> § 7-303(7).

standard provisions.

The plan must be approved by the court if it complies with all the requirements of Chapter VII, is feasible, has been proposed and accepted in good faith, is reasonable in the basis for the valuation, and is fair and equitable (in the highly modified sense that there is a reasonable probability that each class is fully compensated for their interests).<sup>181</sup> After a plan is filed the administrator files an advisory report on the plan similar to the report presently prepared by the SEC.<sup>182</sup> Thus, the SEC has been largely displaced by the administrator. After the plan is filed the court holds a hearing to decide if the plan meets all the criteria. If it does, the court approves the plan and the plan, the administrator's report, any court opinions, and such other matters as the court directs are sent to all parties in interest.<sup>183</sup> Only after the approval and transmittal of information may acceptances be solicited.<sup>184</sup> After a plan has been accepted by the requisite majority and the court finds that it meets all the necessary standards, the plan is confirmed.<sup>185</sup>

Like its predecessors, Chapter VII contains a securities exemption. It states:

No provisions of any law requiring registration of securities or registration or licensing of issuers of securities shall apply to . . . (2) the issuance of any security pursuant to a plan in exchange for securities of the debtor or for allowed claims, or partly in such exchange and partly for cash or property. . . .<sup>186</sup>

The exemption largely parallels §§ 264 and 393, but is intentionally somewhat broader. The provision also extends to all claims, thus eliminating any question concerning post-petition claims by trustees, attorneys, etc. The exemption, however, is not broad enough to include the issuance of securities to any new participants who finance the reorganization.<sup>187</sup>

When viewed in the context of all the proposals, the proposed exemption creates a series of problems any one of which is worthy of more detailed analysis. The major problem comes from the combined effect of the different standards for approval and different

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<sup>181</sup> § 7-310.

<sup>182</sup> § 7-306(b).

<sup>183</sup> § 7-306(c)-(d).

<sup>184</sup> § 7-308. The only exception to this procedure involves plans which do not affect public securities. In such a case an approval hearing is not held prior to the solicitation of acceptances and no report need be filed. See § 7-307, § 7-306, Comment 3.

<sup>185</sup> § 7-310.

<sup>186</sup> § 7-314.

<sup>187</sup> § 7-314, Comment 3.

methods of valuation. Initially it must be noted that it was the standards of fairness in Chapter X and XI which were used to breathe some substantive restrictions into §§ 264 and 393. It is just these standards which have been modified.

The feasibility test of Chapters X and XI has been retained, but its meaning is limited to its present Chapter X interpretation. It seems designed to check only "the likelihood of insuing liquidation or further reorganization."<sup>188</sup> Thus it appears to place no substantive restriction on the value of securities. The good faith test is also carried forward. While it would probably continue to bar the use of the proceedings as a sham for the public distribution of securities, any further restrictions on the securities issued appears unlikely. A "fair and equitable" test is inserted, but it carries totally different statutory connotations than those present in Chapter X. The meaning is restricted to the proposed "modified" absolute priority rule. At this point it is sufficient to note that this "modified" fair and equitable rule is restricted to a single statutory meaning and thus cannot form the basis for substantive restrictions on the value of the securities issued. Even this modified standard would not apply if the plan does not adversely effect public securities holders and if the plan is unanimously adopted after full disclosure.<sup>189</sup> Thus, unlike the present Chapters, there is little room for arguing that the standards imposed on the plan impose any minimum qualitative standards on the securities issued pursuant to the plan.

The lack of qualitative standards becomes acutely evident when the valuation scheme is analyzed in the context of the "modified" fair and equitable rule.<sup>190</sup> One commentator has stated that what the commission actually proposed was to "effectively abolish the rule."<sup>191</sup> While as a general statement that conclusion may be subject to debate, it is certainly true insofar as the present fair and equitable rule imposed a minimum quality standard on reorganization securities. This is chiefly a result of § 7-310 which imposes the "restriction" that there be "a *reasonable basis* for the valuation on which the plan is based and the plan is fair and equitable in that there is a *reasonable probability* that the securities issued and other consideration distributed under the plan will fully compensate the respective classes of

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<sup>188</sup> King at 435.

<sup>189</sup> § 7-310(d)(2)(B).

<sup>190</sup> For a more detailed analysis of these problems see Brudney, *The Bankruptcy Commission's Proposed "Modifications" of the Absolute Priority Rule*, 48 AM. BANKR. L.J. 305 (1974) [hereinafter cited as Brudney] and Note, *The Proposed Bankruptcy Act: Changes in the Absolute Priority Rule for Corporate Reorganizations*, 87 HARV. L. REV. 1786 (1974).

<sup>191</sup> Brudney at 308.

creditors and equity security holders of the debtor. . . ."<sup>192</sup> While what is reasonable is open to considerable doubt, it is clear that the proposal was intended to allow, and will allow, highly inflated valuations at least as compared to present standards. The change will result in the highest reasonable valuation.<sup>193</sup>

In addition, if this artificial valuation is not high enough, § 7-303 permits a "second look" at the valuation within five years from confirmation in order to increase the valuation for the benefit of those who were precluded from participation under the "modified" rule. The plan may provide for "delayed participation rights,"<sup>194</sup> presumably some form of contingent stock, which would ripen into full participation within the five years when and if the debtor's financial status warrants it. Thus, holders of what would be worthless stock under the modified rule are not excluded from participation, but may receive new, contingent (but only a little less worthless) stock.

Finally, § 7-303 also permits equity holders to participate in the new equity of the corporation in an amount reasonably approximating the value of any contribution of services, such as continued management, which they make to the debtor.<sup>195</sup> This changes existing case law and can only result in a further dilution of the total equity of the reorganized business.

The combined effect of the changes in the fairness standards and the loosening of the valuation process cannot help but result in the issuance of large quantities of unregistered, nearly worthless securities. Thus the present policy imposing the "requirement of the issuance of fair and sound securities"<sup>196</sup> present in the existing statute is abandoned.

While this may fundamentally alter present reorganization doctrine, it is not violative of existing federal securities policy. That policy is largely disclosure oriented, and the disclosure requirements are far stronger in the proposed act than under existing statutes. Under the proposal the traditional functions of the SEC in reorganization, preparing a report, acting as an advisor to the court, and expressing views on fees and other sundry matters would be shifted from the SEC to the Bankruptcy Administrator. In all cases except those not involving public securities, the administrator must prepare a report and this report must be furnished to all parties in interest

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<sup>192</sup> § 7-310(d)(2)(B) (emphasis supplied).

<sup>193</sup> See Brudney at 317-31.

<sup>194</sup> § 7-303(3).

<sup>195</sup> § 7-303(4).

<sup>196</sup> S. REP. NO. 1916, 75th Cong. 3d Sess. 7 (1938).



along with other court-ordered material before any acceptances may be solicited. Thus if the administrator fulfills his role in the same way as the SEC presently does, the amount of disclosure should be adequate in most cases. Thus, the goals of the securities statutes are actually advanced.

However, this conclusion rests on the ability of the administrator to prepare reports which would enable all parties to make an informed investment decision. Assuming that the SEC is extremely qualified to insure the needed public investor protection because of its extensive experience in these areas, the wisdom of delegating this role to a new agency may be questioned. In this context two more provisions bear some scrutiny. Under § 7-107(c) the administrator must give written notice to the SEC of every case involving a corporation with more than 300 shareholders. Also in a separate provision the SEC is given standing to be heard on all matters in Chapter VII cases.<sup>197</sup> The envisioned role of the SEC is "to participate in an investigation or make available to the trustee or administrator the results of an investigation it conducted prior to the date of the petition."<sup>198</sup> It has been noted that this may be an unrealistic role for the SEC once its mandatory role ceases,<sup>199</sup> but this is not necessarily so. It may well be that the SEC will assume a role similar to that it now occupies in Chapter XI proceedings. Surely the two provisions give the SEC enough flexibility to play as large a role as is needed. Thus the shifting of functions from the SEC to the administrator need not necessarily result in any decrease in investor protections. With the assistance of the administrator the SEC should be more able to focus on abuses of the securities statutes and the adequacy of the disclosure than what it presently is able to do.

Viewing the commission's proposals as a whole one cannot escape the conclusion that in this area their recommendations are a mixed bag. While the departure from all qualitative fairness standards is not in itself bad, certainly the encouragement of the issuance of nearly worthless securities is questionable. The increase in disclosure requirements if properly administered is potentially a major advance. Whether it is sufficient to offset the loss in quality depends ultimately on the premise of the whole Securities Act of 1933—that is, given full disclosure, an investor (either alone or with the aid of a professional) is capable of making a sound investment decision.

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<sup>197</sup> § 2-205(b).

<sup>198</sup> § 2-205, Comment 3.

<sup>199</sup> Brudney at 306 n.3.